FILED
FEB 14 1977
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-1120

STATE OF CALIFORNIA DEPARTMENT OF BENEFIT PAYMENTS and STATE BOARD OF EQUALIZATION,
Petitioners,

vs.

JOHN M. ENGLAND, TRUSTEE IN BANKRUPTCY IN THE MATTER OF SHAKESTEERS COFFEE SHOPS, and UNITED STATES OF AMERICA,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

EVELLE J. YOUNGER
Attorney General of the State of California

ERNEST P. GOODMAN
Assistant Attorney General

TIMOTHY G. LADDISH
Deputy Attorney General
6000 State Building
San Francisco, CA 94102
Telephone: (415) 557-0792
Attorneys for Petitioners

SORG PRINTING COMPANY OF CALIFORNIA, 346 FIRST STREET, SAN FRANCISCO 94105

SUBJECT INDEX

	Page
Opinions Below	2
Jurisdiction	2
Question Presented	2
Statutes and Court Rule Involved	2
Statement	3
Reasons for Granting the Writ	4
1. The Ninth Circuit Has Misapplied This Court's Decision in United States v. Randall	4
2. The Decision of the Court Below Is an Erroneous Infringement Upon Valid Trust Rights	7
3. The Question Presented Is Clearly of Importance in the Administration of the Bankruptcy Law, the Tax Laws, and the Law of Trusts	9
Conclusion	10
Appendix A	A 1
Appendix B	A 8
Appendix C	A 9
Appendix D	A12
Appendix E	A15

CITATIONS

Cases

	Pages
Elliott v. Bumb, 356 F.2d 749 (9th Cir.), *cert. den.* 385 U.S. 829 (1966)	7
In re Stuck, 13 F.2d 266 (W.D. Mo. 1926)	9
In re Tamasha Town and Country Club, 483 F.2d 1377 (9th Cir. 1973)	4, 6, 7
Jaffke v. Dunham, 352 U.S. 280 (1956)	7
Lusk Corporation v. Arizona Tax Commission, 462 F.2d 187 (9th Cir. 1972)	6, 8
Matter of Centr. R. Co. of New Jersey, 412 F. Supp. 927 (D.N.J. 1976)	6
Otte v. United States, 419 U.S. 43 (1974)	5, 7
United States v. Randall, 401 U.S. 513 (1971)	4, 5, 6, 7, 8, 10
Warren v. Palmer, 310 U.S. 132 (1940)	8-9

Statutes and Court Rules

	Pages
United States Statutes	
Bankruptcy Act	8
Chapter XI	2, 3, 4, 7, 8, 9
Section 62 (11 U.S.C. § 102)	2, 8
Section 64 (11 U.S.C. § 104)	2, 5
26 United States Code § 7501	5, 6
28 United States Code § 960	2, 9
28 United States Code § 1254	2

	Pages
California Statutes	
California Revenue and Taxation Code Section 6455	2-3, 9
California Unemployment Insurance Code Section 1115	3, 9
Court Rules	
Rule 21(4), Supreme Court of the United States	1
Local Rule 408, United States District Court for the Northern District of California	3

Miscellaneous

3A Collier, *Bankruptcy*, ¶ 62.33 (14th ed. 1974)	9

In the Supreme Court of the United States

OCTOBER TERM, 1976

No. .....

STATE OF CALIFORNIA DEPARTMENT OF BENEFIT PAYMENTS and STATE BOARD OF EQUALIZATION,
Petitioners,

vs.

JOHN M. ENGLAND, TRUSTEE IN BANKRUPTCY IN THE MATTER OF SHAKESTEERS COFFEE SHOPS, and UNITED STATES OF AMERICA,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

The State of California Department of Benefit Payments and State Board of Equalization pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, entered in the above-entitled case on November 18, 1976.[1]

1. The United States of America, an appellant with petitioners in the Court of Appeals in this case, has sought an extension of time within which to petition this Court for a writ of certiorari. Rule 21(4) makes the United States a respondent for purposes of the present petition.

OPINIONS BELOW

The opinion of the bankruptcy judge is unreported and is printed in Appendix D hereto, *infra,* pp. A12-A14. The opinion of the District Court, printed in Appendix C hereto, *infra,* pp. A9-A11, is not reported in the official reports but is summarized in the Bankruptcy Law Reporter (1975-1976 Transfer Binder) ¶ 65,849 at 75,580. The opinion of the Court of Appeals, printed in Appendix A hereto, *infra,* pp. A1-A7, is to be published in the official reports but has not yet appeared therein; it has been published in full in the Bankruptcy Law Reporter ¶ 66,301 at 76,101.

JURISDICTION

The judgment of the Court of Appeals (Appendix B, *infra,* p. A8) was entered on November 18, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

When a debtor in possession, acting pursuant to an order of the bankruptcy court in a proceeding under Chapter XI of the Bankruptcy Act, has actually made deposits of taxes in a segregated special tax bank account, and when that debtor subsequently has been adjudicated a bankrupt, is the balance remaining in said special tax account an existing trust fund which is payable to the taxing agencies, or has said balance become a part of the bankruptcy estate which can be applied to the payment of administrative expenses?

STATUTES AND COURT RULE INVOLVED

Reference is made herein to sections 62 and 64a of the Bankruptcy Act (11 U.S.C. §§ 102, 104), 28 U.S.C. § 960, section 7501 of the Internal Revenue Code of 1954 (26 U.S.C. § 7501), section 6455 of the California Revenue and

Taxation Code, section 1115 of the California Unemployment Insurance Code, and local rule 408 of the United States District Court for the Northern District of California as amended to November 1, 1970. Those statutes and that rule are set forth in Appendix E, *infra,* pp. A15-A20.

STATEMENT

A petition under Chapter XI of the Bankruptcy Act was filed by debtor Shakesteers Coffee Shops, a partnership, on January 5, 1971. On January 7, 1971, the bankruptcy court issued an "Order for Payment of Federal and State Taxes", pursuant to local rule 408 (Appendix E hereto, *infra,* pp. A19-A20) of the United States District Court for the Northern District of California. The order directed the debtor in possession "[t]o segregate and hold separate and apart from all other funds" the taxes involved in this case, to open forthwith a "special tax account" in a designated depositary, to make deposits of taxes in this account and to make certain reports concerning the taxes involved and concerning the special tax account. The order also provided that "[t]he amounts deposited therein shall be used and disbursed for the particular purposes for which they are set aside . . . ."

The debtor did open such a special tax account and did make deposits into that account pursuant to the order; debtor also filed some of the reports contemplated by the order. The only payment made from the account was paid to petitioner State Board of Equalization, which applied the payment to reduce debtor's tax liability for the Chapter XI period. At the time of adjudication in bankruptcy, on March 31, 1971, the total amount remaining in the special tax bank account was wholly attributable to outstanding federal and state tax liabilities of the types stated in the order establishing the account.

The bankruptcy judge held that the funds remaining in the special tax account at the time of adjudication were not part of the estate but were trust funds to be distributed to the taxing agencies. (Appendix D, *infra,* pp. A12-A14.) The order of the bankruptcy judge divided the funds between the taxing agencies in a manner agreed upon by those agencies. Thereafter the District Court reversed the order of the bankruptcy judge, holding that under *United States v. Randall,* 401 U.S. 513 (1971), as interpreted in *In re Tamasha Town and Country Club,* 483 F.2d 1377 (9th Cir. 1973), the funds in the special tax account were a general asset of the estate to the extent necessary to pay expenses of administration. (Appendix C, *infra,* pp. A9-A11.) The Ninth Circuit Court of Appeals affirmed on the same grounds. (Appendix A, *infra,* pp. A1-A7.)

REASONS FOR GRANTING THE WRIT

1. The Ninth Circuit Has Misapplied This Court's Decision in United States v. Randall.

In *United States v. Randall,* 401 U.S. 513 (1971), this Court was concerned with a similar situation with one major difference. Like the present case, in *Randall* the debtor in possession under Chapter XI of the Bankruptcy Act was ordered by the court to open a separate tax bank account, to deposit tax amounts therein, and to make tax payments therefrom with the approval of the bankruptcy court. Like the present case, adjudication in bankruptcy followed. Unlike the present case, in *Randall* during the Chapter XI period the debtor in possession totally *failed to comply* with the order's requirement that the tax funds be placed in the special account, although tax funds had been withheld from the wages of its employees. *Id.* at 514. Although the withheld funds in *Randall* could not be traced, the United States claimed a special trust fund status under

26 U.S.C. § 7501(a) (Appendix E, *infra,* p. A18). That argument was countered by an argument "that the debtor-in-possession failed to segregate the taxes so withheld; hence there was no trust." *Id.* at 515. This Court held that the special trust fund status given unsegregated federal tax liabilities by 26 U.S.C. § 7501(a) was a priority which was subordinated to the priorities provided for administrative expenses by section 64(a)(1) of the Bankruptcy Act (Appendix E, *infra,* pp. A15-A17), and that such a holding conformed with the terms of the second sentence of section 7501(a). *Id.* at 515-17.

It is clear that the result in *Randall* would have been otherwise if, as in the case at bar, the debtor in *Randall* had actually made tax deposits in the account which had remained therein at the time of adjudication. In fact, the bankruptcy court in *Randall* had made this distinction. See *Randall* appendix to the briefs, p. 44. Mr. Justic Blackmun, speaking for the four dissenters in *Randall,* noted that "[t]he respondent trustee concedes that if the order had been obeyed, the trustee would have no case. Tr. of Oral Arg. 34." 401 U.S. at 518 (dissent). More recently, in *Otte v. United States,* 419 U.S. 43, 57 (1974), this Court (per Mr. Justice Blackmun) characterized the *Randall* decision as follows:

> "We see nothing in *United States v. Randall,* 401 U.S. 513 (1971), with its observation, *id.,* at 515, that the Bankruptcy Act 'is an overriding statement of federal policy on this question of priorities,' that is contrary to the result we reach here. That case concerned § 7501(a) of the Internal Revenue Code, 26 U.S.C. § 7501(a), with its provision for a trust fund for withheld taxes, and the impact of that statute, *when not complied with,* upon payment of first priority costs and expenses of administration." (Emphasis added.)

Thus it appears that noncompliance by the debtor in possession in *Randall* was an essential, material factor in reaching the *Randall* decision.

Lower federal courts have interpreted *Randall* in this manner. Even a panel of the Ninth Circuit Court of Appeals has characterized the *Randall* decision as concluding "that the federal statute [26 U.S.C. § 7501] which constitutes withheld income taxes a trust . . . *must yield to the requirement of tracing when bankruptcy has intervened.*" *Lusk Corporation v. Arizona Tax Commission,* 462 F.2d 187, 189 (9th Cir. 1972) (emphasis added). More recently, the District Court for the District of New Jersey was confronted with a possibility that the estate of a railroad in reorganization proceedings would be unable to pay all of its administrative expenses. *Matter of Centr. R. Co. of New Jersey,* 412 F. Supp. 927, 931 (D.N.J. 1976). Nevertheless, the Court held as follows as to certain withheld amounts (which we are informed included tax amounts):

> "This Court's Orders No. 792 and 800 required the escrowing of certain withholding amounts. Those funds, to the extent actually escrowed, are trust funds. *United States v. Randall, supra,* is not to the contrary. In this case there was actual escrowing, in the *Randall* case there was not. Such funds should be paid over to the proper entities." *Id.* at 934.

In the case at bar the Ninth Circuit Court of Appeals has misapplied *Randall* by reaffirming its earlier erroneous conclusion in *In re Tamasha Town and Country Club,* 483 F.2d 1377, 1379-80 (9th Cir. 1973), to the effect that the *Randall* result did not rest on the lack of an actual segregation of funds into the separate account. Unlike the *Randall* case and the case at bar, *Tamasha* did not involve a court order to set aside taxes in a separate tax account as those

taxes were withheld or accrued during the continuation of business by a debtor in possession. However, even though this Court's *Otte* decision intervened between *Tamasha* and the present decision, the unnecessary and erroneous conclusion from *Tamasha* was applied by the Court of Appeals in the current case. The carefully phrased statement of *Randall's* material facts by this Court in *Otte,* quoted *supra,* was dismissed by the Court of Appeals as "merely a description of the factual context of *Randall.*" Appendix A, *infra,* p. A6. Thus the Ninth Circuit Court of Appeals has failed to recognize that the debtor's failure to comply with the bankruptcy court's order to make deposits was a necessary factor in the *Randall* decision. Contrary to the Court of Appeals' interpretation, *Randall* did not hold or imply that tax funds actually deposited in a Chapter XI special tax account for specific tax purposes can be used to satisfy administrative expenses after adjudication.

2. The Decision of the Court Below Is an Erroneous Infringement Upon Valid Trust Rights.

Although a person may become bankrupt, property which is held by that person in trust belongs to the beneficiary of the trust. *Elliott v. Bumb,* 356 F.2d 749, 753 (9th Cir.) *cert. den.* 385 U.S. 829 (1966).[2] The question of whether a trust exists with respect to funds which are claimed to be part of a bankruptcy estate is a question to be resolved by reference to state law. *See Jaffke v. Dunham,* 352 U.S. 280, 281 (1956). However, this rule has its logical limits: consistent with the *Randall* decision, a state tax statute which purports to give a special "trust" status to taxes without a requirement of tracing will be recognized as creating, not

---

2. *Elliott v. Bumb* was cited to the court below in the present case and was not disapproved (or even mentioned) in the decision of that court.

a true trust, but " 'a priority in disguise' " which will not be given effect in bankruptcy. *Lusk Corporation v. Arizona Tax Commission,* 462 F.2d 187, 189 (9th Cir. 1972).

In the case at bar all parties have agreed that the taxes which were in the segregated special tax account constituted a completely valid trust under the general provisions of California law. Thus these funds belonged to the taxing agencies involved at the time of adjudication, and could not have become part of the bankruptcy estate at that time. The petitioning state agencies in this case are the beneficiaries of a segregated trust, and seek only the rights afforded any such beneficiary. They do not seek any special trust status under any "disguised priority" tax statute. Although the legislative policy through the years has been to subordinate tax priorities under the Bankruptcy Act to the priorities given to costs and expenses of administration, *United States v. Randall,* 401 U.S. 513, 515-17 (1971), there has been no legislative indication that trust beneficiaries under valid segregated trusts arising during Chapter XI periods will be deprived of their property rights solely because they happen to be taxing agencies.

Respondent trustee argued below that without the use of the trust funds from the special tax account there would be inadequate funds in the estate to pay the expenses of administration. Section 62a.(1) of the Bankruptcy Act provides that the costs and expenses of bankruptcy officers "shall be paid or allowed out of the estates in which they were incurred." This is certainly no authorization to convert funds which are not normally part of the estate into estate funds in order to pay costs of administration. Also, in a proper case the bankruptcy court can charge a fair share of administrative expenses to parties who have benefited from the bankruptcy administration. *See Warren v. Palmer,* 310 U.S. 132, 139 (1940); *In re Stuck,* 13 F.2d 266, 267 (W.D. Mo. 1926); 3A Collier, *Bankruptcy,* ¶ 62.33 (14th ed. 1974). That approach clearly is more equitable and infinitely more legally sound than using the circumstances of a financially depressed estate as a reason for subverting the general laws of trust and appropriating non-estate segregated trust property into the estate.

3. The Question Presented Is Clearly of Importance in the Administration of the Bankruptcy Law, the Tax Laws, and the Law of Trusts.

If the decision of the lower court is allowed to stand, so that the taxing authorities would not be able to rely on tax trust accounts established by the courts, taxing agencies within the Ninth Circuit will be required to take whatever measures are necessary to insure Chapter XI taxes are paid as withheld or incurred, even though such measures would entail greater administrative burdens on the part of the debtor in possession.[3] Also, the inability to rely on a special tax account administered by the bankruptcy court might well lead to more numerous collection controversies between the various state and federal taxing agencies, which controversies would further burden the bankruptcy court and possibly hinder the success of Chapter XI proceedings.

---

3. Under section 6455 of the California Revenue and Taxation Code (Appendix E, *infra,* p. A18) the State Board of Equalization in a proper case could require very short reporting periods for the filing of returns and payment of taxes. The Department of Benefit Payments could take similar action under California Unemployment Insurance Code section 1115 (Appendix E, *infra,* pp. A18-A19). Under the provisions of 28 U.S.C. § 960 (Appendix E, *infra,* p. A17) such actions would be consistent with federal law.

In circuits other than the Ninth Circuit the natural assumption apparently has been that *Randall* did not apply to the present facts. If the present decision is allowed to stand, there will be much confusion in the other circuits which will lead to increased litigation. Such litigation may well lead to further erroneous rulings in some circuits and probable conflict in others. It is of the highest importance that the Ninth Circuit's misapplication of this Court's *Randall* decision not be permitted to stand where it would otherwise almost certainly lead to the disruption of bankruptcy administration in the other circuits as well as within the Ninth Circuit itself.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Dated: February 11, 1977

Respectfully submitted,

EVELLE J. YOUNGER
Attorney General of the
State of California

ERNEST P. GOODMAN
Assistant Attorney General

TIMOTHY G. LADDISH
Deputy Attorney General
Attorneys for Petitioners

(Appendices Follow)

Appendix A

United States Court of Appeals
for the Ninth Circuit

In the Matter of
SHAKESTEERS COFFEE SHOPS, a partnership composed of MILTON KAFFEN, JAMES KAFFEN and JAMES KAFFEN, JR.

JOHN M. ENGLAND, Trustee,
Plaintiff-Appellee,
vs.
UNITED STATES OF AMERICA, STATE OF CALIFORNIA DEPARTMENT OF BENEFIT PAYMENTS AND STATE BOARD OF EQUALIZATION,
Defendants-Appellants.

No. 75-1724
OPINION

[November 18, 1976]
Appeal from the United States District Court
for the Northern District of California

Before: SNEED and KENNEDY, Circuit Judges,
and RICHEY,* District Judge.

RICHEY, District Judge:

The United States, the California Department of Benefit Payments, and the California Board of Equalization have appealed from the district court's decision that funds deposited in a special tax account pursuant to an arrangement proceeding under Chapter XI of the Bankruptcy Act (11 U.S.C. § 701 *et seq.*) should be considered a general asset of the bankrupt's estate and subject to costs and expenses of administration. Appellants contend that a trust fund in their favor was created by the arrangement court's order.

*The Honorable Mary Anne Richey, United States District Judge for the District of Arizona, sitting by designation.

In light of *United States v. Randall,* 401 U.S. 513 (1971), and *In re Tamasha Town and Country Club,* 483 F.2d 1377 (9th Cir. 1973), we find appellants' contentions to be without merit and affirm the decision below.[1]

Shakesteers Coffee Shops, the debtor in these proceedings, petitioned for an arrangement under Chapter XI in January of 1971. Thereafter the arrangement court entered an order for payment of state and federal taxes, directing the debtor to segregate and hold apart from all other funds the taxes accruing on debtor's business operations. The court required the debtor to open a special tax account and to make regular deposits therein of amounts due as tax liability on wages paid to Shakesteers' employees. Pursuant to the arrangement court's order, debtor deposited about $9,000 in the account for withholding taxes, FICA taxes, and certain state unemployment, disability, and sales taxes. Withdrawals were allowed only with joint signatures of the debtor and the referee.

In March of 1971, an arrangement not having been proposed or confirmed, the debtor was adjudicated bankrupt. At that time the funds in the special tax account were turned over to the trustee in bankruptcy and were placed in his trustee account. In February of 1974 the trustee applied for instructions from the bankruptcy court as to the disposition of the proceeds of the special tax account. The trustee was concerned that if the monies in the account were paid over to the state and federal tax entities, there would be insufficient funds remaining for payment of costs and expenses of administration. After a hearing on the matter, the bankruptcy judge issued an order in favor of the tax entities, ruling that the monies in the special tax account were trust funds for the taxing authorities and

1. Jurisdiction is conferred on this Court pursuant to 28 U.S.C. § 1291, and section 24a of the Bankruptcy Act, 11 U.S.C. § 47.

therefore should be excluded from computation of costs and expenses of administration. On appeal by the trustee, the district court reversed the order of the bankruptcy judge. The court held that the funds in the tax account were a general asset of the bankrupt's estate to the extent necessary to pay expenses of administration.

Section 64(a)(1) of the Bankruptcy Act [11 U.S.C. § 104(a)] sets forth the rules of priority for bankruptcy proceedings. It provides in pertinent part:

> The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankruptcy estates, and the order of payment, shall be (1) the costs and expenses of administration . . . (4) taxes which became legally due and owing by the bankrupt . . . which are not released by a discharge in bankruptcy.

In *United States v. Randall, supra,* the Supreme Court construed section 64(a)(1) as an "overriding statement of federal policy on [the] question of priorities." 401 U.S. at 515. There the debtor had entered into arrangement proceedings under Chapter XI and was ordered to establish special tax accounts for withheld income taxes and social security taxes. Although the debtor did withhold taxes, it did not deposit them in the special account. The debtor was subsequently adjudicated bankrupt. The United States argued that the withheld taxes constituted a trust in its favor, relying on section 7501(a) of the Internal Revenue Code.[2]

2. "Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose."

The Court rejected the government's theory, noting that the legislative development of the Bankruptcy Act showed a decline in federal tax preferences and an ascending priority for costs and expenses of administration.[3] The Court stated that the policy of subordinating taxes to costs of administration "would not be served by creating or enforcing trusts which eat up an estate, leaving little or nothing for creditors and court officers whose goals and services created the assets." At 517. Furthermore, the specific priorities of the Bankruptcy Act were held to govern "generalized statutes," such as the Internal Revenue Code, which gave the government priority in a wide range of situations. *Id.*

In *In re Tamasha Town and Country Club, supra,* this Circuit followed *Randall* in holding that the segregation of funds under an aborted arrangement plan did not establish priorities that would supersede an adjudication of bankruptcy. There the government contended that *Randall* was not controlling for three reasons: (1) no reliance was placed on the Internal Revenue Code in *In re Tamasha,* but instead the government based its argument solely on the Bankruptcy Act; (2) there was an actual segregation of funds in *In re Tamasha;* and (3) the judicial confirmation of the arrangement plan prior to the bankruptcy adjudication in *In re Tamasha* allegedly "vested" the parties' rights with respect to the tax funds. 483 F.2d at 1379. Rejecting the attempted distinctions, this Court held that *Randall* did not rest on the juxtaposition of two federal statutes or on the absence of an actual segregation of funds, but rather on the broad congressional policy manifest in the Bankruptcy Act favoring priority of costs and expenses of administration over tax claims. Moreover, in the Court's view, the confirmation of the arrangement plan did not freeze the rights of the parties so as to avoid the provisions of section 64(a). Orders entered pursuant to the arrangement proceedings were binding so long as the proceeding lasted, but were superseded by the subsequent bankruptcy adjudication. In short, "[w]hen the Chapter XI arrangement collapsed, accrued but unpaid taxes became subject to the priorities specified in section 64(a)." At 1380.

3. Until 1926 claims for administrative expenses were subordinate to tax claims. In that year they were placed ahead of taxes. The costs and administrative expenses of a trustee were, however, still subordinate to claims of the referee or creditors for preserving or recovering assets. In 1952 the Act was amended to give priority to administrative expenses of an ensuing bankruptcy proceeding over unpaid administrative expenses of the superseded proceeding." At 516.

Appellants rely on *Otte v. United States,* 419 U.S. 43 (1974), in urging that this Court's former construction of *Randall* was incorrect. They contend that the non-segregation of funds in *Randall* was the determinative factor and that *Otte* supports their argument. However, we find *Otte* inapposite to the issue before us. There the Supreme Court decided that priority claims for wages due and unpaid at the commencement of bankruptcy proceedings were subject to withholding taxes, that tax entities were not required to file proofs of claim, and that the withholding taxes were entitled, as were the wage claims from which they derived, to second priority under section 64(a). In so holding, the Court expressly noted that the issue of a trust fund in favor of the United States was not before it.[4]

Appellants point to *dicta* in *Otte* where the Supreme Court gave a brief explanation of Randall. In rejecting the suggestion that its holding in *Otte* was contrary to *Randall,* the Court stated:

> That case concerned § 7501(a) of the Internal Revenue Code, 26 U.S.C. § 7501(a), with its provision for a

4. There the trustee had paid the priority wage claims, with the taxes withheld and set aside, pursuant to an agreement that the rights of the parties would not be affected thereby. The Court stated that the United States, therefore, was "not in a position to claim that a trust fund [had] been established under § 7501(a) of the Internal Revenue Code, 26 U.S.C. § 7501(a)." At 55 n.8.

> trust fund for withheld taxes, and the impact of that statute, when not complied with, upon payment of first priority costs and expenses of administration. *Randall* is not a holding, as the trustee would claim . . . that the withholding taxes do not have the same priority as the wage claims themselves. At 57-58.

According to the cited passage, *Randall* involved the impact of section 7501(a) when not complied with, *i.e.,* when withholding taxes are not segregated in a special fund. Significantly, the Court did not intimate that the result in *Randall* would have been different had there been a segregation of funds. Rather, the *dicta* would seem to be merely a description of the factual context of *Randall.* In light of *Randall's* broad language regarding the legislative development of the Bankruptcy Act and the congressional intent manifest in the statute, we reaffirm this Court's earlier position that the rationale of *Randall* was the paramount policy of secton 64(a) favoring administrative expenses over tax claims.

In the instant case we find that the goal of sound administration in bankruptcy would not be furthered by recognition of a trust fund created pursuant to the unsuccessful arrangement proceeding.[5] Here, the funds deposited in the

5. We recognize that valid and superseding trust funds in favor of taxing authorities may be created under certain circumstances. *See generally* 4A COLLIER ON BANKRUPTCY § 70.25 (14th ed. 1972). For example, in *In re Matter of Rohar Associates,* 375 F. Supp. 637 (S.D.N.Y. 1974), involving a dispute between certain tax claimants and a general creditor of the bankrupt, the court found that funds deposited in a special tax account were held in trust for the taxing authorities and were not part of the bankrupt's general estate. There, the debtor had maintained a special tax account for several years prior to the bankruptcy filing and had deposited therein checks marked "For Taxes." Significantly, this was done pursuant to the debtor's own accounting practices and not by court order. The district court distinguished *Randall* on the grounds that in *Randall* the disputed funds were *"taxes withheld subsequent to the filing of the petition,* and not deposited in a segregated account." At 639 (emphasis added).

special tax account derived from proceeds of the debtor's ongoing business operations during the arrangement period. When the debtor was adjudicated bankrupt, no arrangement plan had been confirmed, and the bulk of the tax monies remained undistributed. The order for segregation of tax funds was superseded by the bankruptcy adjudication, and such adjudication related back to the original filing of the Chapter XI petition. *In re Tamasha, supra,* at 1380; *Miller v. Wooley,* 141 F.2d 837 (9th Cir. 1944). Thus, upon adjudication of bankruptcy, the monies segregated during the arrangement period became subject to the priorities specified in section 64(a).

Affirmed.

Appendix B

JUDGMENT

United States Court of Appeals
for the Ninth Circuit

In the Matter of Shakesteers Coffee Shops, a partnership composed of Milton Kaffen, James Kaffen and James Kaffen, Jr. John M. England, Trustee, Plaintiff-Appellee, v. United States of America, State of California Department of Benefit Payments and State Board of Equalization, Defendants-Appellants.	No. 75-1724 DC# Bkcy B-3-71-14 SAW

Appeal from the United States District Court for the Northern District of California.

This Cause came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

On Consideration Whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

Filed and entered November 18, 1976

Appendix C

Original Filed Oct 30 1974
Clerk, U.S. Dist. Court
San Francisco

In the United States District Court
for the Northern District of California

No. 3-71-14 SAW

In re Shakesteers Coffee Shops,
Bankrupt.

MEMORANDUM AND ORDER

In this action, the Trustee appeals from the order of the Bankruptcy Court requiring distribution of the debtor's tax account to the State and Federal tax creditors.

No facts are in dispute. The proceeding was commenced under Chapter XI of the Bankruptcy Act on January 5, 1971. On January 7, 1971, the Bankruptcy Court, pursuant to Local Rule 408, directed the debtor to establish a tax account for payment of Federal and State taxes accruing during the Chapter XI proceedings. On March 31, 1971, the debtor was adjudged bankrupt. The Bankruptcy Court ordered the $8,128.13 balance remaining in the tax account to be paid to the State and Federal taxing authorities. The Trustee contends that the balance in the tax account should have been declared a general asset of the bankrupt estate to the extent necessary to pay all administration expenses, in accordance with the priorities established in § 64a(1) of the Bankruptcy Act. The State and Federal claimants assert that the tax account constituted a specific trust fund created for their benefit which was not a general asset of the bankrupt estate.

The Trustee bases his appeal on the decisions in *United States v. Randall,* 401 U.S. 513 (1971) and *In re Tamasha Town and Country Club,* 483 F.2d 1377 (9th Cir. 1973). In

Randall, the Bankruptcy Court had ordered the debtor to deposit in a special tax account all taxes withheld, collected, or incurred by him during the pendency of Chapter XI bankruptcy proceedings, but the debtor failed to comply. The Supreme Court held that the Government's claim for withholding taxes must be subordinated in payment to the costs and expenses of the bankruptcy proceeding. In *Tamasha,* the Bankruptcy Court had ordered, as a condition to confirmation of an arrangement plan, the creation of a fund to pay priority creditors pursuant to § 337(2) of the Bankruptcy Act and upon adjudication the funds had not been disbursed. The Ninth Circuit held that the pre-Chapter XI tax claim was not entitled to priority over the claims for costs of administration.

The IRS and the State of California attempt to distinguish *Randall* and *Tamasha* from the present case on the grounds that: (1) *Randall* did not involve a specifically segregated trust fund, and (2) unlike *Tamasha,* deposits made to the tax account here were not generated from the general assets of the debtor. Upon a close reading of both *Randall* and *Tamasha,* this Court has concluded that neither decision turned on those particular facts.

Justice Douglas, writing for the Court in *Randall,* spoke in broad terms of the overriding federal policy in bankruptcy which subordinates tax claims to administrative expenses. 401 U.S. 513, 515-517. Judge Hufstedler, who wrote the Ninth Circuit opinion in *Tamasha,* construed *Randall* in a manner this Court finds persuasive:

> In Randall, the trustee argued that since the debtor in possession had failed to segregate the taxes withheld, no trust in favor of the United States resulted.... Instead of adopting this argument, the Court chose to place its ruling on the survey of legislative developments favoring administrative expenses over tax claims and on the overriding policy of section 64a....

But see: United States v. Randall, supra, 401 U.S. at 518 (Blackmun, J., dissenting); *Lusk Corporation v. Arizona State Tax Commission,* 462 F.2d 187, 189 (9th Cir. 1972).

In *Tamasha,* the deposits to the debtor's tax account came from general assets, whereas in the present case the tax deposits involved were paid into the debtor's tax account as they were withheld or incurred. The State argues that the Ninth Circuit was motivated in *Tamasha* by the feeling that it would subvert the Bankruptcy Act to take money from the general funds of the estate, put it in a special account, and then not to reinsert the funds in the general estate if a bankruptcy were adjudged before transfer of the funds under the plan. Although such a limitation of *Tamasha* is conceivable, this Court is persuated that both *Randall* and *Tamasha* stand upon the broader policy grounds made explicit in the opinions. The court in *Tamasha* quoted (at 483 F.2d 1379) the following passage from *Randall:*

> We think the statutory policy of subordinating taxes to costs and expenses of administration would not be served by creating *or enforcing* trusts which eat up an estate, leaving little or nothing for creditors and court officers whose goods and services created the assets. 401 U.S. at 517. (Emphasis added.)

The same policy covers the present case, and, accordingly, this Court is of the opinion that the order of the Bankruptcy Judge must be reversed.

IT IS HEREBY ORDERED that the decision of the Referee Bankruptcy Judge is reversed. This case is remanded for further proceedings consistent with this order.

Dated: October 30, 1974.

STANLEY A. WEIGEL
Judge

Appendix D

Filed—Apr 29 1974
Lynn J. Gillard
Bankruptcy Judge

United States District Court
for the Northern District of California

No. 3-71-14 SAW

In re
Shakesteers Coffee Shops, a partnership composed of Milton Kaffen, James Kaffen and James Kaffen, Jr.,
Bankrupt

John M. England, Trustee
Plaintiff

vs.

United States of America
California Department of Employment Development
California State Board of Equalization
Defendants

OPINION

The trustee filed herein on February 4, 1974, an "Application for Instructions" relative to an Order for Payment of Federal and State Taxes made in the superseded Chapter XI proceeding. At the hearing on said application for instructions, the court directed that the same be treated as a motion as defined by Bankruptcy Rule 901(9) and directed that defendants file answers thereto, and that the matters be submitted on the facts alleged in the pleadings.

This Chapter XI proceeding was commenced on January 5, 1971, and the order for payment of federal and state taxes was entered on January 7, 1971. Pursuant thereto the debtor made deposits in said account in January, February and March and made one payment therefrom of $1,100.00 to the State Board of Equalization for sales taxes. On March 31, 1971, when the debtor was adjudicated a bankrupt, there was a balance of $8,128.13 on deposit in said tax account, all of which is claimed by the defendants herein. The trustee requests that these funds be treated as general assets of the estate and be expended in the order of priority established by Section 64 of the Bankruptcy Act.

It is common knowledge that the suppliers of personal property to debtors in Chapter XI arrangement proceedings require payment in cash upon delivery of such goods to the debtor. Suppliers of services have more difficulty placing the debtor upon a cash basis, but some, like public utilities, can achieve this end by requiring deposits to protect future charges. In this connection, the courts have even sanctioned deposits sufficient to guarantee the payment of the pre-existing debt owing to a telephone company as a condition of continued service during the Chapter XI proceeding. Slenderella Systems of Berkeley Inc., v. Pacific Telephone & Telegraph Company (2nd Cir. 1960) 286 F.2d 488; Rothman v. Pacific Telephone & Telegraph Company (9th Cir. 1971) 453 F.2d 848.

The order entered in this proceeding concerning the payment of federal and state taxes was an attempt to place the taxing agencies insofar as possible on a cash basis with the debtor. The order was drafted several years ago at the request of and with the assistance of those taxing agencies, to implement local Rule 408. It was designed (1) to give prompt notice to the taxing agencies of the fact that the order was being complied with (by requiring duplicate deposit slips to be mailed to them) (2) to prevent the debtor from using such tax funds for operating expenses,

and (3) to assure that such funds would be paid to the taxing agencies entitled thereto. To effectuate that purpose the order provides that "the amounts deposited therein shall be used and disbursed for the particular purposes for which they are set aside and shall be withdrawn only by the issuance of a check signed jointly by the authorized signatory of the debtor in possession and the referee in bankruptcy".

There is nothing in the letter or spirit of the Bankruptcy Act which prohibits a debtor in possession from being placed on a cash basis as a condition of continuing in business, and there is nothing in the letter or spirit of the Bankruptcy Act which prohibits the court from expressly providing for the payment of taxes incurred during the proceeding. In my opinion, Local Rule 408 is within the rule making power of this court, and the order issued pursuant thereto is within the jurisdiction of the court pursuant to Section 2(15) of the Bankruptcy Act. By its clear provisions, the order establishes a trust fund for the payment of those taxes, and it would be contrary to the purpose and intent of said order to comply with the trustee's request.

The funds held in the debtors tax account are not part of the debtors estate, but are trust funds held for defendants herein, and shall be distributed to them. The amount held in said accounts shall be excluded from the computation of the net realization of the bankruptcy estate for the purpose of computing the trustee's commissions and for the purpose of computing the amount payable to the referee's salary and expense fund.

The defendants shall prepare an appropriate order consistent herewith.

Dated: April 29, 1974

LYNN J. GILLARD
Bankruptcy Judge

Appendix E

Section 62 of the Bankruptcy Act (11 U.S.C. § 102) provides in pertinent part:

> a. (1) The actual and necessary costs and expenses incurred by officers, other than referees, in the administration of estates shall, except where other provisions are made for their payment, be reported in detail under oath, and examined and approved or disapproved by the court. If approved, they shall be paid or allowed out of the estates in which they were incurred.

Section 64a of the Bankruptcy Act (11 U.S.C. § 104) provides:

> a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment shall be (1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; the fees for the referees' salary and expense fund; the filing fees paid by creditors in involuntary cases or by persons other than the bankrupts in voluntary cases; where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, is recovered for the benefit of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors, the reasonable costs and expenses of the recovery; the trustee's expenses in opposing the bankrupt's discharge or in connection with the criminal prosecution of an offense punishable under chapter 9 of title 18 of the United States Code, or an offense concerning the business or property of the bankrupt punishable under other laws, Federal or State; the fees and mileage payable to witnesses as now or hereafter provided by the laws of

the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the bankrupt in voluntary and involuntary cases, and to the petitioning creditors in involuntary cases, and if the court adjudges the debtor bankrupt over the debtor's objection or pursuant to a voluntary petition filed by the debtor during the pendency of an involuntary proceeding, for the reasonable costs and expenses incurred, or the reasonable disbursements made, by them, including but not limited to compensation of accountants and appraisers employed by them, in such amount as the court may allow. Where an order is entered in a proceeding under any chapter of this Act directing that bankruptcy be proceeded with, the costs and expenses of administration incurred in the ensuing bankruptcy proceeding, including expenses necessarily incurred by a debtor in possession, receiver, or trustee in preparing the schedule and statement required to be filed by sections 238, 378, or 483, shall have priority in advance of payment of the unpaid costs and expenses of administration, including the allowances provided for in such chapter, incurred in the superseded proceeding and in the suspended bankruptcy proceeding, if any; (2) wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; and for the purposes of this clause, the term "traveling or city salesman" shall include all such salesmen, whether or not they are independent contractors selling the products or services of the bankrupt on a commission basis, with or without a drawing account or formal contract; (3) where the confirmation of an arrangement or wage-earner plan or the bankrupt's discharge has been refused, revoked, or set aside upon the objection and through the efforts and at the cost and expense of one or more creditors, or, where through the efforts and at the cost and expense of one or more creditors, evidence shall have been adduced resulting in the conviction of any person of an offense under Chapter 9 of Title 18 of the United States Code, the reasonable costs and expenses of such creditors in obtaining such refusal, revocation, or setting aside, or in adducing such evidence; (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further,* That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court; and (5) debts other than for taxes owing to any person, including the United States, who by the laws of the United States is entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law or who is entitled to priority by paragraph (2) of subdivision c of Section 67 of this Act: *Provided, however,* That such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupancy of the premises affected, and which accrued within three months before the date of bankrtupcy.

28 U.S.C. § 960 provides:

> Any officers and agents conducting any business under authority of a United States court shall be subject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation.

Section 7501 of the Internal Revenue Code of 1954 (26 U.S.C. § 7501) provides in pertinent part:

> (a) *General Rule.*—Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

Section 6455 of the California Revenue and Taxation Code provides:

> The board [State Board of Equalization], if it deems it necessary in order to insure payment to or facilitate the collection by the State of the amount of taxes, may require returns and payment of the amount of taxes for quarterly periods other than calendar quarters depending upon the principal place of business of the seller, retailer or purchaser as the case may be, or for other than quarterly periods.

Section 1115 of the California Unemployment Insurance Code provides:

> (a) If the director finds that the collection of any contributions will be jeopardized in any case where an employing unit is insolvent, or is delinquent in a substantial amount of contributions due under this division, or is about to discontinue business at any of its known places of business, or the business is of a temporary or seasonal nature, the director may, upon giving the employing unit 10 days' notice:
>
> (1) Require payment of contributions with respect to wages paid from the beginning date of the calendar quarter in which notice is given to the date designated in the notice.

> (2) Require payment of contributions for reporting periods less than calendar quarters.
>
> (b) As used in this section "reporting period" means that period less than a calendar quarter which is established by the director.
>
> (c) Contributions required under subdivision (a)(1) of this section are due and payable on the date designated in the notice and shall become delinquent if not paid within 10 days of the due date.
>
> (d) Contributions required under subdivision (a)(2) of this section are due and payable on the first day of the reporting period following the close of each reporting period and shall become delinquent if not paid within 10 days of the due date.
>
> (e) The employing unit shall file within the time required for payment of contributions under this section a return in such form and containing such information as the director prescribes.
>
> (f) Notices under this section may be served either personally or by mail, addressed to the employing unit at the same address that appears on the records of the department. Service is complete at the time of deposit in the United States mail.

Local rule 408 of the United States District Court, Northern District of California, Local Rules of Practice, as amended to November 1, 1970, provided:

> Rule 408. Deposits of Tax Collections by Debtor in Possession
>
> (a) Deposits and Withdrawals. In all cases under Chapters X, XI and XII of the Bankruptcy Act where the debtor is by court order permitted to remain in possession of his estate, he shall immediately deposit in one of the designated depositories of this court all monies then held or thereafter received or collected for and on behalf of the United States, any state, or any political subdivision thereof, for excise, entertainment, withholding, social security, sales or unemploy-

ment taxes or contributions. The deposits shall be made in the name of the debtor in a separate account designated "Debtor's Tax Account". Withdrawals from the account shall be made only by check signed by the debtor and the referee after the filing of a request to sign checks or, if no reference has been made, by the debtor and the clerk or his deputy.

(b) Monthly Statement Concerning Taxes. Unless otherwise ordered by the court, every debtor in possession authorized to operate a business shall file a monthly statement showing the amount deducted in the preceding month for withholding, social security and other payroll taxes, the amount of sales tax collected, and that paragraph (a) has been complied with during that period.

(Since July 16, 1974, the provisions of former local rule 408 have been contained, with an additional provision regarding special payroll accounts, in local rule 411.)